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**Employee Share Incentive Schemes –  
The taxation of the old and the “new”**

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Employee Share Incentive Schemes

It is hereby confirmed that this technical report constitutes my own work and no outside assistance has been received in its preparation. All sources used have been referenced and are accurately defined herein.

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# **1 Introduction**

The main objective of any employee share incentive scheme introduced by an employer to its employees, no matter what the actual benefits of the scheme or the format in which it is construed, is to retain valuable employees and to provide them with an incentive to work hard to develop the business of the employer, as they now have a stake in its equity. In return by offering this “incentive” the employer is hoping that the growth in business result in the growth of the value of the shares.

In providing a share incentive scheme as an incentive to employees there is, however, relevant tax issues that need to be considered from the perspective of the employer and employee, as with any other benefit or remuneration being offered to employees. The objective sought to be achieved by the operation of a share incentive scheme is to enable employees to participate in the growth of the company while seeking to ensure that minimal tax is paid on the growth of such an employee’s participation in a scheme.

The objective of this report will thus be not only to look at the different types and operation of traditional employee share schemes and the newly introduced broad- based employee scheme but to furthermore try and establish whether there is any “real benefit” from a tax perspective for an employee participating in a share incentive scheme, whether traditional or a broad- based share scheme. If any, what are the alternative options available?

## **1.1 Layout of the report**

The relevant provisions of the Income Tax Act, No. 58 of 1962 (“the Act”) will be discussed and considered in light of the above as well as the South African Revenue Services (“SARS”) practice and approach towards the different employee share incentive schemes being implemented.

The relevant legislative provisions will firstly be set out and discussed and the reason for recently promulgated changes affecting share incentive schemes. Secondly the different types and operation of traditional and “new” employee share incentive schemes will be discussed and the tax implications for employees of the different schemes.

The report will conclude as to whether participation in an employee share incentive scheme is true benefit for an employee from an tax perspective and if any what other options can an employer provide to an employee which is more tax effective.

## 2 Relevant provisions of the Act

The relevant provisions of the Act pertaining to employee share incentive schemes, from an employees' tax perspective, can be grouped in the following categories:

- Certain provisions of the definition of “gross income” in section 1 of the Act. The relevant provisions of “gross income” discussed below are further of relevance and should be read with the following categories of the Act.
- The provisions of section 8A of the Act that deals with the taxation of gains that arise when an employee exercises his or her right to acquire marketable securities in terms of participation in an employee share scheme.
- The recently promulgated section 8B of the Act that deals with the taxation of amounts derived from a broad-based employee share scheme.
- The taxation of directors and employees on the vesting of equity instruments in terms of the newly promulgated section 8C of the Act.
- The provisions of the Seventh Schedule to the Act that deals with the taxation of benefits derived by reason of employment or the holding of any office.
- The relevant provisions of the Eighth Schedule to the Act which determine the capital gains tax implications of participation in an employee share incentive scheme.

### 2.1 The “gross income” definition

The definition of “gross income” in section 1 of the Act forms the basis of the South African income taxing structure and if an amount cannot be brought within the ambit of “gross income” it will not attract tax.

The definition includes any amount which is received or that accrues to a taxpayer in a year of assessment, excluding receipts and accruals of a capital nature.

Paragraph ( c ) of the definition of “gross income” further includes:

- Any amount , including any voluntary award, received or accrued in respect of services rendered or to be rendered; or
- Any amount received or accrued in respect of or by virtue of any employment or the holding of any office; provided that
- The provisions of paragraph ( c ) shall not apply in respect of any benefit or advantage in respect of which the provisions of paragraph ( i ) of the definition apply.

Paragraph ( i ) of the definition of “gross income” state that the cash equivalent, as determined under the provisions of the Seventh Schedule to the Act , of the value of any benefit or

advantage granted in respect of employment or to the holder of any office, and any amount required to be included in the taxpayer's income under Section 8A of the Act.

Paragraph ( c ) will be of importance where paragraph ( i ) of the definition , and therefore section 8A , do not apply. This will especially be relevant where the taxpayer is not a director or employee , thus not in employment or the holder of any office, but an independent contractor.

The meaning of paragraph ( c ) has been considered in the case of *Mooi v CIR* ( 1972 ( 1 ) SA 675 (A), 34 SATC 1) where the taxpayer was granted the option to subscribe for shares in his employer company. The offer was subject to the conditions that the offer was only exercisable until 6 months after a certain date in future and that the option could only be exercised if the taxpayer was still employed.

The dispute concerned the year of assessment in which an amount was to be included in the "gross income" of the taxpayer as a result of the granting of the option and the amount so to be included. The case was decided on the law as it stood before the introduction of section 8A on the meaning of paragraph ( c ) of the definition of "gross income" being that any amount, including any voluntary award, received or accrued in respect of services rendered or to be rendered. The taxpayer further contended that the amount to be included by way of paragraph ( c ) of "gross income" was the value of the option at the time that he accepted it whilst the Receiver of Revenue contended that it should be the difference between the market value of the shares at the time the options were actually exercised and the option price. The court further held that accrual only took place when the option became exercisable and not when the offer was accepted.

## **2.2 Section 8A of the Act**

As stated above paragraph ( i ) of the definition of gross income includes any amount in a taxpayer's income under section 8A of the Act. The heading of section 8A is " gains made by directors of companies or by employees in respect of the right to acquire marketable securities.

From the heading of section 8A it is clear that the section deals with a gain made as oppose to receipts and accruals referred to in paragraph ( c ) of the definition of "gross income".

Section 8A includes in the income of a taxpayer any amount of a gain made by the taxpayer after the first day of June 1969, by the exercise, cession or release of any right to acquire any marketable security, whether in whole or part, if such right was obtained before 26 October 2004 as either a director of a company or in respect of services rendered or to be rendered as an employee to an employer.

It should be noted that section 8A of the Act is only applicable to share options granted until 26 October 2004. In terms of the Revenue Laws Amendment Bill 24 of 2004 , section 8A is repealed and section 8C , which will be dealt with below, will apply to all employee share options granted after that date.

A further provision of section 8A will apply where a taxpayer has exercised a right and is only entitled to dispose of the marketable security in a subsequent year of assessment because of a condition imposed by the employer or the grantor of the right.

In such cases the taxpayer may elect in terms of the provisions of section 8A(1)(c) that the gain arising as the result of the exercise of a right is to be taxed not in the year of exercise of the right, but in the year in which the taxpayer becomes entitled to dispose of the marketable security concerned. For this section to apply the election must be made in writing and given to the Commissioner during the year of assessment in which the right is exercised.

Where the election has been made and death or insolvency intervenes before the time the marketable securities are disposed of, the gain is deemed to have been made on the day before the date of death or insolvency.

The section defines the gain made by a taxpayer in section 8A(2) as follows:

- A gain is deemed to have been made by the exercise of a right to acquire a marketable security, if the amount by which the market value of the marketable security at the time when the right is exercised, exceeds the aggregate of the consideration given by the taxpayer for the marketable security and any other consideration for the right or the grant of the right.
- The market value is deemed to be the sum for which a person having a right to dispose of the marketable security might expect to obtain from the sale of that security on the open market.
- If the right to acquire the marketable security is ceded or released, the gain made is defined as the "amount by which the amount or value of the consideration received for the cession or release, exceeds the amount or value of the consideration given by the taxpayer for the right or the grant of the right concerned."

The meaning of section 8A was considered in the case of *SIR v Kirsch* (1978 (3) 93 (T), 40 SATC 95). A director of a company was offered shares in a company for recognition of services rendered to the company's subsidiaries in Israel. The director accepted the offer and the shares were allotted to him, resulting in a gain.

It was first argued whether section 8A would apply or not. The taxpayer argued that section 8A dealt only with options, and not with an offer of sale. The word "right" was to be construed as to mean a legally enforceable right only that would arise under an option agreement once both parties had accepted the terms of the agreement. It was argued by the taxpayer that no such right arose where an offer to sell shares was made. The court disagreed with this argument, holding that there was no reason why the legislator, when it dealt with a type of commercial activity where a right means an option, should have intended to limit the operation of section 8A to rights in the strict sense of options. It was therefore held that section 8A would apply in this case. In *ITC 1493* (53 SATC 187) it was held that the right, is the right enjoyed by the taxpayer to bring into existence by his voluntary and unilateral act of exercise on acceptance a contract entitling him to claim the shares.

The next point considered by the court in *SIR v Kirsch* was whether the taxpayer had obtained the right in question as an employee or as a director. The distinction is important, as section 8A makes no reference to source

In this case the normal rules therefore applied being that the gain accruing to the taxpayer in his capacity as director would generally have its source at the place that his duties as director are carried out, where the board meetings are held. In the Kirsch case this was held to be in Johannesburg.

In the same instance, where an employee is granted a taxable right as the result of services rendered, the source of the right would be the place where the services are rendered. In the Kirsch case the majority of the services were rendered in Israel , with the balance in South Africa.

At the time of the Kirsch case , South Africa still taxed on a source basis and resulted in that the gain derived from a non-South African source was not taxable in South Africa.

Since 2000 South Africa tax residents are now taxed on their world-wide income, including gains made under section 8A. The question of source remains important , especially in the case of non-resident expatriate employees, since countries may tax gains on source basis. The application of double taxation treaties may be affected by the ability to determine what portion of the gain is attributable to one country or the other.

## **2.3 Section 8B of the Act**

The new section 8B inserted by section 8(1) of the Revenue Law Amendment Act, No 32 of 2004 , is effective as from 26 October 2004 and deals with the taxation of amounts derived from broad-based employee share schemes..

In terms of section 8B there will be included in the taxable income of an employee an amount received or accrued during the year of assessment from the disposal of any qualifying equity share or any right or interest in a qualifying equity share, which

- Was acquired by the employee in terms of a broad-based employee share scheme; and
- Is disposed by the employee within five years from the date of grant of that qualifying equity share.

A “qualifying equity share” as defined in section 8B must satisfy the following two requirements :

- The shares must be received by the employee in terms of a broad-based employee share scheme, and
- The total market value of the shares received under the scheme do not exceed R9 000 in total during any three year period.

In terms of section 8B a broad-based employee share scheme must comply with the following requirements:



- The employer must offer the shares to the employees for either no consideration or minimal consideration which does not exceed the minimum consideration required by the Companies Act , No 61 of 1973. Loans may be offered at a nil interest rate or below the current prescribed rate of 8,5 % in order to assist the employee with acquiring the shares , if needed. This will not be viewed as a taxable benefit in terms of the current provisions of the Seventh Schedule to the Act.
- The employer must further offer the broad-based share scheme to at least 90% of its employees who have been permanently employed on a full time basis for at least one year. This will ensure that widespread participation is achieved .
- In terms of a broad-based share scheme the employees must have full voting and dividend rights in the shares offered in terms of the plan, ensuring that the employees acquire an ongoing equity interest.
- A broad-based scheme is not allowed to contain any disposal restrictions in terms of section 8B other than the following:
  - A restriction imposed by legislation;
  - A right of any person to acquire those equity from the employee at market value, or
  - A restriction in terms of which an employee may not dispose of the equity shares for a period which may not extend beyond five years from the date of the grant.

In terms of section 8B, the ordinary income provisions will apply when an employee sells the qualifying equity shares within five years from the date the shares was granted. If the shares are sold after the five year period, the employee's gains on the proceeds of the sale will be of a capital nature and will be subject to capital gains tax at the capital gains tax rate for individuals, after the deduction of the annual capital gains tax exemption.. Should the shares be sold within the five year period the proceeds will fall within the employee's gross income and be subject to normal income tax. This is aimed at encouraging the employees to retain the shares for more than five years.

Employers are currently not entitled to any tax deductions for shares that are directly issued to employees. The reason for this being that the issuing of shares is not viewed as an expense actually incurred in the production of income, which is required to qualify for a deduction in terms of section 11(a) of the Act. If a broad-based scheme is structured and implemented correct, this may be to the advantage of small to medium sized employers to be able to claim such a deduction.

However, with the introduction of section 8B employers will be entitled to a deduction equivalent to the market value of the shares issued to employees, limited to R3000 per year per employee in terms of section 11(1 A) of the Act.

## 2.4 Section 8C of the Act

Section 8C was inserted by section 8(1) of the Revenue Laws Amendment, No 32 of 2004 and came in effect as from 26 October 2004, and is thus applicable in respect of any equity instrument acquired on or after that date, otherwise than by way of the exercise of any right granted before that date in respect of which section 8A applies.

The new section 8C deals with the taxation of directors and employees on the vesting of equity instruments by virtue of his or her employment or office of the director of any company. As mentioned above, the provisions of this new section apply to the acquisition by an employee of an equity instrument, which includes an option to acquire a share, on or after 26 October 2004.

Therefore in terms of section 8C, the emphasis will no longer be on when the ownership of a share has been acquired but on when the vesting of an equity instrument takes place.

Taxpayers will therefore now be taxed on the gains that arise pursuant to the vesting of an equity instrument. Prior to the vesting of an equity instrument, any amount received by, or that accrued to a taxpayer is therefore exempt from tax and should they acquire an equity instrument prior to vesting it will be ignored for income tax purposes. This is to ensure that the limited section 8A gains that arose from certain share schemes do not “escape” the tax net and that the “actual” gain are now taxed.

The vesting of an equity instrument will take place before the disposal of the equity instrument, immediately before a taxpayer dies and whenever an option in relation to a “restricted equity instrument” terminates. In terms of section 8C a taxpayer will therefore no longer be able to escape taxation by choosing not to exercise an option. If there is a value in the option when it terminates, the taxpayer will have to account for income tax in respect of such a gain.

An “equity instrument” is defined as a share or part thereof in the equity share capital of a company, an option to acquire such a share, and any other financial instrument that is convertible to a share.

Section 8C further differentiates between restricted and unrestricted equity instruments. A “restricted equity instrument” includes any equity instrument which is subject to any restriction, other than a restriction imposed by legislation, that prevents the taxpayer from freely disposing of the equity instrument at market value. The following are also deemed to be restrictions placed on an equity instrument:

- Where an employee cannot freely dispose of a share at fair market value. This would also apply where an employee is not entitled to dispose of the shares for the first five years.
- Forfeiture restrictions will apply where shares can potentially be sold at less than the fair market value. This would be applicable where an employee must sell the shares back to the employer either because the employee resigns within the five years or employment is terminated within such period.

- It is further stipulated in section 8C that an equity instrument would also be considered to be restricted, should the company undertake to cancel the transaction or repurchase the equity instrument at a price exceeding its market value on the date of repurchase, if there is a decline in the value of the equity instrument after acquisition. The share will thus become a restricted equity share instrument with the result that the employee will have to account for the tax implications whenever the share is sold at the original value.
- Where there are options on restricted equity instruments it will seem to be acquiring a “restricted equity instrument” and although the option is freely tradable, the termination or non-exercise of the option will result in the vesting of the restricted equity instrument.
- If a financial instrument is converted into a share it will also be a restricted equity instrument and the debt will carry restricted status.

Vesting in terms of a “restricted equity instrument” will thus only take place when the restrictions in relation to that type of equity instrument are lifted. Irrespective of whether the employee becomes the owner of the shares before the restriction is lifted, it is only once the restrictions have been lifted that the income tax consequences arise.

When a restricted or unrestricted equity instrument thus vests, a taxpayer will have to account for income tax on the difference between any amount paid for the shares and the market value of the shares whenever it vests. Should the vesting result in a loss for a taxpayer it will be deductible for income tax purposes.

This provision can have far reaching consequences for taxpayers as should an employee resign within five years after receiving options and never exercised the options he will be taxed on the value of the options at the time he resigns. The tax consequences arise, therefore irrespective of whether or not the option is exercised.

The same will apply where an employee purchases shares for R50 and are restricted to sell the shares for five years. When the restriction is lifted, the period of five years lapsed the employee will be taxed on the difference between the market value in five years and the R50 he paid for the shares. This can have huge tax implications for shares that shown a huge growth in five years time. Taxpayers will also not be able to argue anymore that the gain made is of a capital nature because the shares have been held for five years.

## 2.5 Seventh Schedule to the Act

As stated above under the definition of “gross income” paragraph (i) of the definition include within its ambit the cash equivalent, as determined under the provisions of the Seventh Schedule, of the value of any benefit or advantage granted in respect of employment or the holder of any office

Paragraph 2(a) of the Seventh Schedule deals with the acquisition of assets by an employee either for no consideration or for a consideration at less than their actual value. An asset is defined as follows:

- Goods;
- Commodities;
- Marketable securities; and
- Property of any nature excluding money.

The paragraph further states that the provisions of the subparagraph will not apply in respect of

- Any marketable security acquired by the exercise of any right to acquire any marketable security as contemplated in section 8A;
- Any qualifying equity share acquired by an employee in terms of section 8B; or
- Any equity instrument as contemplated in section 8C.

The above do therefore exclude any shares acquired in terms of sections 8A, 8B and 8C from the ambit of paragraph 2(a) of the Seventh Schedule.

The provisions of paragraph 2(f) of the Seventh Schedule deem a taxable benefit to be granted to an employee where loans are provided to employees at less than the official rate of interest which is currently 8,5 %

Where a loan or credit is extended to employees in respect of share acquisition at a rate less than the official rate will thus fall within the ambit of paragraph 2(f) of the Seventh Schedule and be taxable in the hands of the employee.

The cash equivalent of the value of the taxable benefit arising from the low interest or interest-free loan will be calculated as the excess of the interest which would have been paid on the loan had it borne interest at the official rate, over the interest, if any, actually incurred by the employee.

## 2.6 Eighth Schedule to the Act

In terms of paragraph 35(3)(a) of the Eighth Schedule to the Act the gain made by a taxpayer pursuant to the exercise of his options in terms of a share incentive scheme will not be subject to capital gains tax ("CGT") to the extent that the amount must be or has been included in the taxpayer's gross income in terms of section 8A, section 8B or section 8C of the Act

When a taxpayer disposes of shares at a future date or subsequent to the exercise of an option it would constitute a disposal for capital gains tax ("CGT") purposes in terms of the Eighth Schedule to the Act. In terms of paragraph 3 of the Eighth Schedule to the Act, the capital gain would be the amount by which the proceeds received on the disposal of the asset exceed the base cost of that asset.

The question would then arise as to whether the base cost would be the amount the employees paid for those shares, or the market value of the shares. Paragraph 20 of the Eighth Schedule, which deals with the determination of the base cost of an asset, includes the following:

- Where an amount was included in a person's gross income either as a taxable benefit in terms of the Seventh Schedule of the Act, or in terms of section 8A, the value placed on the asset in terms of the Seventh Schedule will be the base cost of the shares; and
- In the case of an equity instrument which results in the determination of a gain or loss in terms of section 8C, the base cost of the shares will be the market value of the equity instrument which was taken into account in determining the amount of the gain or the loss.

### **3 Reasons for changes to the legislation affecting share incentive schemes**

The legislation as it stood before the introduction of section 8B of the Act, did not encourage the transfer of free or discounted shares to employees on a broad basis.

Before the recent changes to legislation low-income earners may be forced to sell the shares they obtain to pay the tax levied thereon. Equally employers would be less inclined to grant such incentives if they cannot claim a deduction in terms of section 11(a) of the Act.

Recognising the motivational effect on productivity acquiring a “stake” in a company may have been the reason for the introduction of section 8B to promote the broad-based employee schemes allowing all employees to obtain shares in their employer’s company at a minimal tax cost.

Previously, share incentive schemes were effective in limiting the taxable value of shares granted to a participant either by deferring the payment of taxes due.

With the amendments introduced with section 8B and section 8C a participant will now be taxed on the benefit accruing at the date the participant obtains unrestricted access to the share or as stated in the Act when the equity instrument vests.

In terms of section 8B the tax concessions with regard to broad-based schemes are two-fold. The employer will be entitled to a deduction for income tax whilst the employees will only be taxed on the disposal of the shares and only when they have unrestricted access to the shares. Section 8C will not afford the same tax concessions as section 8B but rather aim to bring within its ambit the “loopholes” not covered by section 8A, such as the minimal gain subject to tax where deferred delivery schemes are implemented.

It is however apparent that higher ranking employees would not be able to use the tax breaks of the broad-based schemes to procure the same tax benefits as afforded under the more traditional share schemes.

## **4 The traditional types of share incentive schemes**

There are many existing share incentive schemes in place and implemented by employers, all with varying tax consequences. Before discussing the various share incentive schemes that exists, the use of a share incentive trust to implement a share incentive scheme will be briefly be commented on.

### **4.1 The use of a share incentive trust**

The advantages of using a share incentive trust are as follows:

- the trust deed contains terms and conditions aimed at retaining employees and limiting the costs for the company should an employee be dismissed or resign shortly after acquiring shares;
- the trust deed regulates voting rights and the determination of prices in the case of the disposal of the shares. The management and control of shares destined for employees is thus facilitated; and
- the company may also make loans via the trust to salaried directors to enable them to acquire shares in the company. Section 38 of the Companies Act does not allow the granting of financial assistance to executive directors to acquire shares in the company if a trust is not used.

The use of such trusts is thus general practice by most employers implementing share schemes. The company does not issue shares directly to employees but acquire their shares in the company via the trust.

The trust is established and acquires shares in the company. The company can issue the shares to the trust or the trust can purchase shares from existing shareholders.

The trust borrows the issue price/purchase price of the shares from the company. Section 38 of the Companies Act allows the granting of financial assistance by a company to a trust for the acquisition of its shares for the benefit of its employees.

Depending on which scheme is implemented, the trustees will either grant options or make offers to employees to purchase shares (or make provision for both).

Employees may either pay in cash for their shares or the purchase price may be owing to the trust on loan account. If on loan account, the shares are pledged to the trust as security for repayment of the loan. Typically, the rate in respect of the loans made by the trust equates the loan granted to the employee. The loans may also be interest free. The Interest free and low interest rate loans have employees' tax implications, as contemplated in the relevant provisions of the Seventh Schedule of the Act.

When the employee pays the purchase price of his shares or his share loan to the trustees, the latter utilise the funds to repay the trust's loan from the company.

## **4.2 Traditional share purchase scheme**

### **4.2.1 Implementation of the scheme**

The employer sets up an *inter vivos* employee share incentive trust (“the share trust”) for the benefit of its employees and specifically for share incentive scheme purposes.

The share trust then either purchases or subscribes for shares in the employer company. With this scheme selected employees, usually the more high ranking employees, are given the opportunity to buy the shares at the prevailing market value on the date an offer is made to them by the share trust. Upon acceptance of the offer by the employee, which may be within a certain period, a binding sale agreement arises and the shares are registered in the name of the employee.

The participating employees are not required to pay for the shares offered to them until a specified future date, usually in tranches over three to ten years. The employees will thus be indebted to the share trust to the extent of the purchase price of their shares and will have an interest bearing or interest free loan account owing to the company. As security for the repayment of the purchase price and the interest thereon, if any, the shares are pledged back to the share trust.

Dividend income that may accrue to the employees on these shares, will firstly be used to pay employees tax on the loan and, secondly, to pay interest (if any) on the loan.

After the qualifying period, employees may either continue to hold the shares or sell the shares back to the trust at the then market value.

### **4.2.2 Tax consequences of the scheme**

The main advantage of the share purchase trust is that if the shares are purchased at the current market value by the employees, the provisions of section 8A and section 8C will not be deemed to be a gain to have arisen upon the acquisition of the shares unless the shares are purchased at less than the market value.

The low-interest or interest free loans which are granted to the employees to purchase the shares will be deemed to be a taxable benefit in terms of paragraph 2(f) of the Seventh Schedule to the Act. Employees’ tax need to be withheld on the amount equal to the difference between the interest calculates at the current official rate of interest of 8,5% and the interest charged on the loan.

### **4.2.3 Advantages and disadvantages of the scheme**

The main advantage of implementing the traditional share purchase scheme is that financial assistance is made available to the employees to participate in the scheme and the employees obtains immediate equity participation by obtaining the shares.



A further advantage is that should the employees acquire the shares at the current market value there will be no taxable gain arising in their hands in terms of section 8A or section 8C of the Act. If not the provisions of section 8C will be applicable in future and the employees taxed on possible gains that will result because of the vesting of the shares.

A disadvantage of this scheme more specific for the employees is that employees need to fund the existing share value whilst targeting the benefits associated with the future growth, represented by higher returns, in the value of their shares. However, this may not materialize. The fact that the employees are “locked” in the purchase contracts upfront strengthens the risk of financial loss should the market price of the shares fall below what they paid for the shares. Section 10(1)(n E) of the Act provides that if the sale is cancelled or the shares repurchased from the employee at the original purchase price paid by the employee, that the employee will not be taxed on the amount received by the employee for the shares.

Employers should thus provide for a “stop-loss” protection clause in the scheme so that employees are effectively protected against any financial loss on the disposal of their shares without them suffering any adverse tax consequences and making it attractive for its employees.

A further disadvantage, again for the employee is that should interest not be charged on the loan it will constitute a taxable benefit in their hands and with the abovementioned growth that may not materialize it will only be a “cost burden” to the employees being offered to purchase shares in the company.

The disadvantage to the employer is that they are not entitled to any tax deductions for shares issued directly to employees in terms of section 11(a) of the Act as it is not viewed to be an expense actually incurred in the production of income.

Should employers choose to continue with a traditional share purchase scheme the tax treatment will not change from that discussed above and the provisions of section 8C will thus apply as from 26 October 2004 onwards.

Should an employer wish to implement a broad based share scheme as defined in section 8B of the Act it will have to be offered to at least 90% of the employees who have been permanently employed on a full-time basis for at least one year and all other requirements with regard to a broad-based scheme regarding dividend rights and disposal restrictions. .

The big advantage to the employer will be that they will be entitled to claim a deduction equivalent to the market value of the share issued to the employees, although it will be limited to R 3 000 per year per employee in terms of section 11(l A).

## **4.3 Share option schemes**

### **4.3.1 Implementation of the scheme**

Selected employees are granted options either by the employer company or a share trust to purchase or subscribe for the company’s shares at a fixed price, which is usually the market value at the date of granting the option.

The options that are granted to the employees are usually exercisable over a three to ten year period. The option will lapse upon termination of the employee's service or if it is not exercised within a certain time limit. The shares are purchased via a share trust which holds the shares to which the employees' options attach.

The employees do not acquire the shares or earn any dividend income and there is no obligation to pay the purchase or subscription price of the shares until the employees exercise the option.

Upon the exercise of the option the agreed purchase price is paid and the trust delivers the scheme shares to the employee upon full payment by the participant.

#### **4.3.2 Tax consequences of the scheme**

As there is no loan or credit extended to the employees as with the share purchase scheme there will thus be, no taxable benefit in terms of the Seventh Schedule to the Act.

The gain made by the employee pursuant to the ultimate exercise of the option is taxable in the hands of the employee in terms of the provisions of section 8A of the Act and on or after 26 October 2004 when a share vests in terms of the provisions of section 8C. The gain made in terms of section 8A will be the difference between the market price of the shares at the date the option is granted and the market price at the date the option is exercised. The effect of section 8C will be the same as that of section 8A, in that the employees will also be taxed on the gains they make on the exercise of the options. This gain will not be subject to capital gains tax ("CGT"), in terms of paragraph 35(3) (a) of the Eighth Schedule to the Act, to the extent that the amount has been included in the employee's income either in terms of section 8A or 8C of the Act.

To retain the services of employees, certain trust deeds contains a provision restricting the employee from selling the shares for a certain period of time after the date on which the option was granted. For options granted prior to 26 October 2004 an employee could elect in writing to the Commissioner that the gain only be included in the employee's taxable income in the year in which the employee becomes entitled to dispose of the shares. In the case of options granted after 26 October 2004 it will be included in the taxable income of the employee when the share vests and there is no provision allowing to apply for a deferment where a gain is made by an employee.

Any further gain made by the employees on the disposal of the shares subsequent to the exercise of the option will not be subject to income tax but may be subject to CGT. The base cost of the shares for CGT purposes will be the market value of the shares on the date the option is exercised. If the market value of the shares at that date is equal to or less than the market value on the date the option was granted, the base cost of the shares will be the consideration price paid by the employee to acquire the shares.

### **4.3.3 Advantages and disadvantages of the scheme**

As stated above the advantage from an employees' tax perspective is that there is no fringe benefit implications during the period that the options are held as there is no loan or credit extended to the employees.

A further advantage for employees of a share option scheme as oppose to a share purchase scheme is that they are not "locked" into buying the shares, as with the share purchase scheme, until they exercise their options. The financial risk as with the share purchase scheme, due to fluctuations in the value of the shares, is thus absent in this case.

Any gain made by the employee will however be taxable either in terms of the provisions of section 8A or section 8C depending on when the share options are granted to employees.

The employee therefore obtains the right to participate in the growth in the value of the shares between the time the share option is granted and the point at which the option is exercised. However, the participant does not obtain immediate equity participation.

With a share option scheme the ownership culture amongst employees is only created when the option is exercised.

## **4.4 Deferred implementation option scheme**

### **4.4.1 Implementation of the scheme**

A contract is concluded between the employer company or the share trust and selected employees. In terms of the contract the company or the share trust agrees to issue or sell shares to the selected employees who agrees to subscribe for or purchase such shares on the basis that the payment for and delivery of the shares to the employee is deferred over a certain period, which is usually three to ten years. The option must be exercised within a short period after the granting thereof. If the option is not exercised timeously, the option lapses.

The subscription or purchase price is the market price of the shares at the time of the conclusion of the contract. Furthermore the subscription or purchase price is only payable at the time of the delivery of the shares to the employee and must be paid in full at that time.

Prior to the delivery of the shares and the payment of the purchase price the employee receives no dividends or other benefits attached to the shares.

### **4.4.2 Tax consequences of the scheme**

As with the traditional share option scheme, the sale of the shares is effectively a cash sale and no loan or credit is extended to the employees. Thus, provided it is implemented correctly, no taxable benefit will arise in the hands of the employees in terms of the provisions of paragraph 2(f) of the Seventh Schedule to the Act.

Prior to the introduction of section 8C these schemes, if implemented correct, the provisions of section 8A did arguably not apply and employees were not taxed on any gain when ownership of the shares is transferred to the participant. The fact that the contract concluded do not involve the granting of a right to acquire a share, and any gain made by the employee will not be subject to section 8A of the Act. There is still a risk that a taxable benefit may arise by virtue of paragraph 2(a) of the Seventh Schedule as a marketable security will be acquired by the employee for a consideration, the market price on the date of the conclusion of the contract, which is less than the market value of the asset on the date the shares are delivered and payment is made.

However, with the introduction of Section 8C this “loophole” is closed because irrespective of when the employee exercises his option the shares will only vest once it is paid by the employee and the shares transferred to the employees. In most cases this will result in a taxable gain in the hands of the employees in terms of section 8C.

For capital gains tax purposes in terms of paragraph 13 of the Eighth Schedule, the conclusion of the contract and the subsequent payment of the purchase price will not trigger a capital gains tax liability in the hands of the employee. However, if the employee sells the shares after delivery and payment of the purchase price, this will trigger a capital gains tax liability in the hands of the employee.

#### **4.4.3 Advantages and disadvantages of the scheme**

As with the traditional share option schemes the employees do not need financial assistance upon the exercise of their options.

These schemes are regarded as being tax aggressive and the correct implementation thereof is thus critical. The South African Revenue Services challenges this mechanism, maintaining that where all the employees exercise their options immediately , and the payment and delivery only take place at a later stage, that the existence of an option appears to be a “sham”. The argument being that any increase in the market value of the share should be valued for tax purposes not on the date of the exercise of the option but from the date of the exercise of the option to the date of the delivery of the share.

With the introduction of section 8C of the Act the deferred delivery option schemes will not be as popular as before as the employee will be taxed on the gain when the share vests and will thus be the difference between the market value when the option were exercised and the market value when the shares are paid for and transferred.

### **4.5 Phantom share schemes**

#### **4.5.1 Implementation of the scheme**

This is scheme is not a true share incentive scheme in the sense that no actual shares are issued to the employees. Units or “phantom” shares are allocated to employees either by a company or share trust. As these are not actual shares it does not entitle the employee to any rights in respect

of the actual shares. Instead, these schemes amount to a contract between the company or share trust and each employee whereby the employee receives what is, effectively, a bonus.

In most cases each unit entitles the employee to receive an amount equal to the dividend declared in respect of an actual share.

Upon the expiry of certain time periods, the holder of a unit is paid an amount equal to the market value of an actual share or the growth in the market value since the allocation date of the unit.

#### **4.5.2 Tax consequences of the scheme**

The allocation of the share units does not immediately create any unconditional and absolute rights and obligations in the hands of either the company or the employees. Consequently, the mere allocation of the share units does not result in any tax consequences on the date of the allocation.

With phantom share schemes there is no loan or credit extended to the employees and there will thus be no taxable benefit in terms of the Seventh Schedule of the Act.

Prior to 26 October 2004 the provisions of section 8A would not apply as the employee does not obtain a right to acquire a marketable security. After 26 October 2004 the provisions of section 8C will also not be applicable as there is no vesting of an equity instrument.

The amounts paid to the employees are analogous to bonuses and will, accordingly, be subject to income tax in the hands of the employees at their marginal tax rates.

#### **4.5.3 Advantages and disadvantages of scheme**

The advantage of implementing a phantom scheme is that the administration of the scheme is simple as it does not require the issue or purchase of shares. The employees further do not require funding to participate in the scheme.

Phantom share schemes are not as attractive to employees as they do not acquire “actual shares” that may be held for investment purposes, or disposed of to realize their value. These schemes therefore do not confer any rights or ownership to the employees, it merely establishes a benchmark for determining the amount of the bonus. Furthermore, as it is not actual shares the employees acquire, the employees do not receive any dividends in respect of the share units.

## **5 The “new” share incentive schemes**

With the introduction of section 8B and section 8C effective as from 26 October 2004 it introduces a new dispensation for employees participating on share incentive schemes and for their employers. It is said that the amendments have brought much needed certainty in respect of the implementation of staff retention and motivation policies.

From the provision of section 8B and more specific section 8C it is clear that higher ranking employees would not be able anymore to use the same the same tax breaks to procure similar taxation benefits as afforded in terms of the provisions of section 8A of the Act.

From the relevant legislative provisions and the traditional type of share incentive schemes discussed above it is evident that previously certain share incentive schemes were effective in limiting the taxable value of shares granted to a participant and in certain cases to defer the payment of the related tax. With the new provisions the benefit of the option to defer the payment of tax has been closed down.

### **5.1 The new Broad-based share incentive scheme**

The Fiscus have recognised that the acquisition of shares by employees, over and above their standard salary, can have the effect of motivating productivity. The reason for this would be that employees obtain a stake in the company and thus have vested interest in the future growth of the company.

Could this be the reason for the Fiscus to introduce the new section 8B with special “tax rules” to promote long-term, broad-based employee empowerment by allowing all employees to participate in the success of their employer at minimal tax cost?

With section 8B the employer is encouraged to set up a broad-based share scheme for the benefit of its employees and to pass full equity shares to the participants, the employees will have nothing to lose by taking up the shares offered to them, and the Fiscus is prepared to forego the taxation on the “free award” of shares to the employees and unlike with the old traditional share schemes to allow the employer to deduct the cost of the shares awarded to employees, although there is limitations to this.

The benefit for the employees participating in a broad-based share scheme are that they will only be taxed on the disposal of the shares, and then only on the proceeds of the disposal if the shares are sold after a five year period from the date that the shares are granted. The proceeds of the disposal will thus only be taxable at the capital gains tax rate for individuals, after the deduction of the annual capital gains tax exemption for individuals which could result in no tax that need to be deducted. This thus entails that should the employee sell the qualifying equity shares after 5 years the gain will generally be of a capital nature and will not deem to be remuneration as defined in the Act. As unlike with other share schemes and in light of the provisions of section 8C where the tax event occurs when the participant obtains unrestricted access to the share and the taxable benefit is calculated using the full market value of the share at that date.

Should the employees however dispose of the “equity shares” within 5 years from the date the shares were granted it will trigger an employees’ tax liability. The disposal of the shares within the 5 year period will effectively amount to be a “salary substitute” or remuneration as defined and the employer will thus need to withhold employees’ tax. The market value of the shares sold, on the date of the sale will be the amount subject to tax and will be deemed to be an annual payment made to the employee.

Section 8B do however have very specific requirements for a scheme to qualify as a broad-based scheme as discussed under section 2.3. In essence it is a share scheme that will provide real access namely dividend and voting rights to real equity share capital for at least 90% of an employers permanent staff who do not already participate in some other form of share scheme.

What does this mean to the employer? Yes, this does mean that shares will be distributed to a majority of lower-ranking employees, however, with the proper administration of such a scheme it will be to the benefit of the employer in the form of an allowable deduction, although within limits, an empowered and motivated workforce and possibly a beneficial Black Economic Empowerment rating. Implementing a broad-based scheme will result in costs relating to training, payroll and administration but can be controlled and managed by the employer. For a broad-based scheme to work optimally it will be best, as with other traditional schemes to “house” the shares through a share trust and with employer representatives appointed to educate and ensure that dealings with the employees is a streamlined process.

The new section 8B has created some much needed flexibility in the field of direct ownership opportunities although it is anticipated that its various ambiguities will attract much debate and possible further amendments.

## **5.2 Section 8C share scheme**

Equity instruments provided by an employer to employees on or after 26 October 2004 which do not fall under section 8B or which were acquired otherwise than by way of the exercise of any right granted by that date, in respect of which section 8A applies, should be dealt with in terms of the new section 8C of the Act.

In terms of section 8A a taxable gain in one form or the other arose where the acceptance of an offer; the exercise of an option or the awarding of a share occurred.

In terms of the provisions of section 8C the “ownership” of shares acquired through a share incentive scheme will not play a significant role anymore as the provisions of section 8C revolves around the gain that arise when the “vesting” of a restricted or unrestricted equity instrument takes place.

The effect of section 8C of the Act is therefore to tax the gain in respect of an equity instrument upon the vesting of such gain, if the equity instrument were acquired by the employee or director by virtue of his or her employment. The effect of section 8C should be the same as that of section 8A of the Act, in that the employees will be taxed on the gains they make on the exercise of share options in the year of assessment in which such options are exercised. The gain will be the amount by which the market value of the shares on the date the option is exercised exceeds the consideration paid in respect of such an option.

Therefore, prior to the vesting of the equity instrument, any amount that would be received by or accrue to the taxpayer will be exempt from tax and should the taxpayer acquire the equity instrument prior to it vesting it will be ignored for income tax purposes.

Section 8C(3) of the Act sets out the situations in which an equity instrument is deemed to vest in an employee as follows:

- In the case of unrestricted share options , it will be at the time of the acquisition of the shares( i.e the date the employees exercise their right to acquire the shares),
- In the case of a restricted equity instrument , when all the restrictions have been lifted and the employee is free to dispose of the shares. This does not necessarily mean that the taxpayer must first exercise the option, or dispose of the shares but that the instrument must be capable of being exercised and/or disposed of;
- Immediately before the employee disposes of restricted shares;
- When an option in respect of shares terminates;and
- Immediately before the employee dies.

As stated above the employer will thus need to withhold employees' tax from gains made by employees in terms of section 8C in the month that the equity instrument vests.

However, in terms of paragraph 11A(2) of the Fourth Schedule to the Act, the employer is only obliged to withhold employees' tax once it becomes aware of the exercise or vesting of the right granted to the employees to acquire the shares. This may prove to be a contentious issue in any possible future cases regarding section 8C.

In light of all the relevant provisions of section 8C and the possible disastrous consequences an employer need to apply the normal taxation principles but further consider a lot of underlying aspects. One of the aspects that need to be considered is where section 8C will apply to restricted options with unrestricted underlying equity instruments and the tax implications thereof.

One can assume the following situation:

An employee acquires (for no consideration) an option to purchase a share in his employer company for R6. The option is restricted in that it cannot be freely disposed of. The share, if purchased, is not subject to any restrictions for the purposes of section 8C.

Per the provisions of section 8C(3)(b)(ii), a restricted option vests when the option "terminates". An option can terminate in one of two ways – lapsing or exercise. If the option is exercised, the restrictions fall away, and the option vests. Assuming that at the time of exercise the market value of the share is R8, the option now has an inherent "market value" of R2, being the maximum amount that a buyer would be willing to pay for an option to buy a share worth R8 for R6. The gain to be included in the taxpayer's income for the purposes of section 8C(2)(a)(ii)(aa) will therefore be R2, being the market value of the option of R2 less the consideration paid for the option of nil.



As the share is unrestricted, it vests at the time of acquisition; in other words, at the time the option is exercised. At this point, the gain for the purposes of 8C(2)(a)(ii)(aa) is R2, being the market value of R8 less the consideration paid of R6. At this time, paragraph 20(h)(i) of the Eighth schedule to the Act deems the base cost of the share acquired to be the market value used for the purposes of section 8C – in other words, the base cost is now R8. Assuming the taxpayer now sells the share for R10, he will incur a capital gain of R2, being the R10 proceeds less the R8 base cost. To summarise, he has incurred the following taxable gains:

On the vesting of the option (s8C):  $(R2 - R0) = R2$  (taxed at his maximum rate)  
 On the vesting of the share (s8C):  $(R8 - R6) = R2$  (taxed at his maximum rate)  
 On the sale of the share:  $(R10 - R8) = R2$  (50% taxed at his maximum rate)

In the situation described above, the taxpayer is subject to income tax on the same R2 of income on two occasions. The “gain” that is taxed on the vesting of the option is the same gain that is taxed on the vesting of the share, as the option draws its value from the value of its underlying instrument. The sum of the transactions is that the taxpayer has acquired a share worth R8 for R6, but has been taxed on a R4 gain instead of a R2 gain.

An alternative view is that the exercise of the option and acquisition of the share is an event considered in section 8C(1)(b)(i), which states that section 8C does not apply in respect of an equity instrument which was acquired in exchange for the disposal of another equity instrument which had already vested for the purposes of the section. In other words, the share which was acquired via the disposal (exercise) of the option which had already vested. The transaction flow is as follows:

The option is exercised, causing it to vest (as the restrictions are lifted on exercise) and the taxpayer is taxed under 8C on the R2 gain made on the option (as described above). The share is acquired for R6, but the difference between the market value of R8 and the acquisition cost of R6 is not taxed under 8C due to the provisions of 8C(1)(b)(i). The base cost of the share is now the actual expenditure, in terms of paragraph 20(a) of the Eighth Schedule (paragraph 20(h)(i) cannot be used to determine the base cost in this case, as section 8C has never applied to the share). Assuming once again that the taxpayer sells the share for R10, the capital gain to be taxed would be calculated based on the proceeds of R10 less the base cost of R6 (being the actual expenditure to acquire the share). To summarise, in this case he has incurred the following taxable gains:

On the vesting of the option (s8C):  $(R2 - R0) = R2$  (taxed at his maximum rate)  
 On the sale of the share:  $(R10 - R6) = R4$  (50% taxed at his maximum rate)

This scenario is obviously more beneficial to the taxpayer, as a greater portion of the overall gain is now taxed in terms of section 26A of the Eighth Schedule, which includes only half the capital gain. Ignoring the benefit, however, the scenario utilising section 8C(1)(b)(i) is the correct description of the transactions and cash flows that have actually occurred, namely:

- the taxpayer acquired a share worth R8 for R6 in terms of an option, and has been taxed on the inherent gain in that acquisition of R2;

- as a result of the acquisition, the taxpayer has a capital asset (a share) with a base cost of R6, being the amount actually paid, and
- on sale of that asset, he has been taxed on the capital gain based on the difference between the proceeds on sale and the cost to him of that asset.

The elimination of the anomalous double-taxing of gains via the application of section 8C(1)(b)(i) hinges on the wording of that section, namely “acquired in exchange for the disposal of any other equity instrument”. The option and the share are clearly separate equity instruments for the purposes of section 8C, and the share is acquired as a result of the exercise of the option. The question is therefore whether or not the exercise of an option constitutes a “disposal” of that option. As “disposal” is not defined directly or indirectly for the purposes of section 8C, the ordinary meaning of the word must be used, namely “the act or means of getting rid of something”. Clearly the exercise of the option achieves the end of “getting rid of” that option – the option has been removed from the exerciser’s possession. This understanding of the phrase, coupled with the fact that it could not be the intention of the legislature to tax the same gain twice under one section, leads to the conclusion that the section intended section 8C(1)(b)(i) to apply to the exercise of an option and the consequent acquisition of an unrestricted share.

The anomaly discussed above arises from the fact that options are treated as separate equity instruments for the purposes of section 8C. In practice, an option is in itself valueless unless it is sold. If it is exercised, it is and has always been merely the right to acquire an instrument for a certain price. If exercised, the option and the instrument acquired merge into one transaction resulting in a gain, and cannot be separately recognised. The gain can either be recognised on the sale of the option or on the exercise thereof and acquisition of an instrument, but not on both.

It is clear from what is discussed above that section 8C with the various scenarios covered by the section may take time to “reveal” themselves and that an employer must take cognizance thereof and come to grips with the new legislation both for planning and compliance purposes.

## 6 Conclusion

As stated in the beginning the objective of any employee share incentive scheme is to enable employees to participate in the growth of the company, retaining valuable staff while seeking to ensure that minimal tax is paid on the growth of such an employee's participation in a scheme.

The introduction of broad-based employee share schemes in terms of section 8B does represent an opportunity to utilize resultant tax benefits and other advantages to both the employer and the employee as discussed.

With the promulgation of section 8C, it did not necessarily result in a "new" type of share incentive scheme as with section 8B and all the traditional share schemes as discussed can still be implemented. The only and major change is with regard to when the tax event is deemed to occur or as referred to in the provisions when the "vesting" of an equity instrument occurs. From an individual's tax perspective the consequences can be more complex than what is read in the provisions of section 8C and as it is apparent from the example discussed with regard to restricted options with unrestricted underlying instruments.

To conclude an employee share incentive scheme, whether a traditional scheme or a broad-based scheme, is still an "attractive" option used by employers to retain and motivate staff. It is only the resultant tax implications of a scheme that needs to be carefully considered and communicated to employees.

Although one will probably need to revisit the true impact of the amendments and the ultimate advantages to employees and employers the amendments aim to bring about some certainty in respect of the implementation of staff retention and motivation policies to decrease staff turnover by giving employees a vested interest in the future of a company and have the potential of broadening Black Economic Empowerment initiatives.

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